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The Manufacturers Hanover
Economic Report

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Senior Vice President
and Economist

MARCH 1984

Is Inflation Imminent?

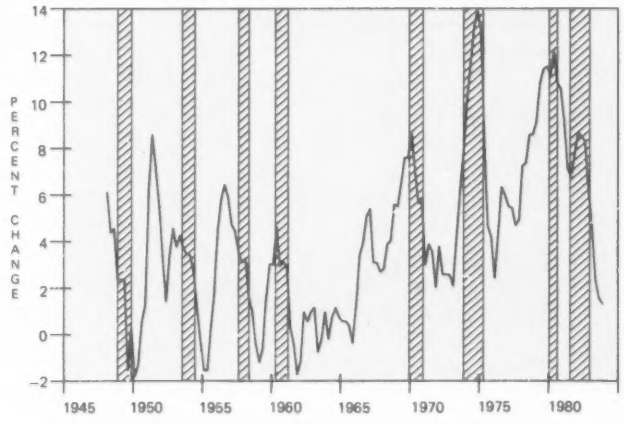
Nowadays, it is difficult to read about the current economic upswing without finding a growing amount of concern being expressed about inflation prospects. This is understandable. As we move further and further away from the 1981-82 recession, memories of its severity and its impact on price and wage decisions tend to fade. Additionally, the rate of inflation has ratcheted upward in every business cycle in over 30 years. Finally, several labor unions whose contracts expire this year are talking about big wage demands, some raw materials' prices seem to be heading up, and the dollar has taken a tumble in world currency markets.

In this profession, one learns, if nothing else, never to say "never." So I am not going to say that we will *never* see double-digit inflation again. However, I would suggest that we are not on the verge of double-digit inflation and are not likely to see double-digit rates of inflation anytime soon. I would define "anytime soon" as the rest of this year and a good part—if not all—of 1985. There are many reasons for this expectation, several of which I offer below.

Wages Rise More Slowly

First and foremost is the labor cost situation. The severe recession of 1981-82 continues to cast its shadow on current labor-management relations. The Labor Department tells us that major collective bargaining contracts settled in private industry last year yielded the lowest average wage adjustments in the history of this series. Wage adjustments under the contracts negotiated called for an average rise of 2.6 percent in the first year and 2.8 percent annually over their life. The last time the same parties bargained (two to three years ago, in most cases), average wage adjustments were 9.3 percent in the first contract year and 6.8 percent annually over the contract life. Additionally, one-fourth of these workers last year had their wages either frozen or decreased. A fairly widespread (if unusual) phenomenon during the recession, these wage "give-backs" are apparently continuing through the economic recovery. To make matters more interesting, they have spread to those companies and industries which are relatively profitable, as management seeks to make labor costs more competitive.

CHART I
NONFARM UNIT LABOR COST INDEX
(PERCENT CHANGE FROM A YEAR AGO)



Not surprisingly, employers' wage bills are rising much more slowly in this economic expansion than they have, on average, in the past. And when productivity growth is factored in, one finds that labor costs per unit of output in many sectors of the economy are either flat or declining. (Chart I). The biggest improvement in productivity has come in the manufacturing sector, as is usually the case, but the outlook is brightest in the service sector, thanks to the increasing application of new technologies. As long as productivity growth continues strong and wage settlements are moderate, unit labor costs will not rise rapidly. Since labor costs comprise approximately two-thirds of business costs, you can see why this trend alone should make one optimistic about inflation prospects.

International Factors Hold Prices Down

Notwithstanding the importance of labor costs, there are plenty of other reasons to expect the rate of inflation to remain moderate in the months immediately ahead. The degree to which the dollar has soared since mid-1980 has profoundly affected both

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business and labor in the United States. The strong dollar has opened previously closed markets to foreign competition because the cost of importing fell significantly as the dollar's foreign exchange value rose. In addition, because the strong dollar also meant that goods produced in the United States intended for sale abroad became very expensive, the net result was an overabundance of goods in the U.S. and a reduced ability on the part of many companies to raise selling prices. While the dollar has declined somewhat from its earlier peak, it is still believed to be significantly overvalued, compared with many other currencies, thus it is still keeping downward pressures on prices.

In this connection it might be worth noting two more factors on the international scene which will tend to keep a lid on prices. The first is the generally sluggish economic recovery worldwide. Most other countries that normally import goods manufactured in the U.S. are only now beginning to experience the first stirrings of an economic upswing. Obviously, slow growth limits their appetite for imported goods. In addition, the problems of some developing countries in servicing promptly their outstanding external debts suggest that they will be less in the market for imports, and will place greater emphasis on exports. This is because they have to turn around their trade positions from deficit to surplus, if they are to earn enough money to service their debts. Clearly, this will further increase the supply of goods on the market.

One item that is in big supply internationally is oil. It should not be forgotten that a good part of the reason for the escalation of inflation over the past ten years has been the sharp rise in the price of oil. But energy prices are no longer being set by only one side of the market. The balance between supply and demand has clearly tilted in favor of oil users. In spite of the tensions in the Middle East, this outlook is unlikely to change anytime soon. Our imports of crude oil and products have dropped significantly over the past ten years and are now at the lowest level since 1972. We are using no more gasoline today as a nation than we did back in 1973 with 24 percent more cars on the road. Industry's usage of residual fuel oil for heating and electric power generation is at its lowest level in over 30 years. Overall, our ratio of energy input to GNP output has changed dramatically from the 1:1 that characterized the half century to 1973, to as little as 1:6 today.

A good part of the reason for this better balance between supply and demand has come about because of deregulation. Begun in April 1979 by President Carter, deregulation was accelerated in January 1981 by President Reagan, who completely decontrolled domestic crude oil prices. The impact of removing these controls was dramatic: spot oil prices peaked shortly thereafter and have declined 33 percent since. A story similar to oil industry deregulation can be told for natural gas which is only partially decontrolled. Beginning in late 1979, as the prices of some categories of gas were decontrolled, levels of exploration for these types of gas rose as did its availability. As a result, prices of some types of natural gas fell about two-thirds at the wellhead, although, because of the partially decontrolled nature of natural gas markets, this drop is not yet fully visible in end-use prices.

The Importance of Deregulation

Energy is not all that has been decontrolled. Indeed, quite a few sectors have been deregulated with favorable results on supply and demand, thus, prices. Most prominent is the transportation sector. The Airline Deregulation Act of 1978 terminated the Civil Aeronautics Board's authority over domestic routes effective December 1981 and over domestic pricing effective January 1983. As a consequence, competition within the industry has increased, witness the fact that the number of certified airlines rose from 36 in 1978 to 154 currently. Removal of price controls and the increase in the number of airlines have caused prices to fall in many markets. Nearly twice as much domestic coach traffic operates under discount pricing today compared with six years ago. Deregulation has also promoted efficiencies within the airline industry as carriers have been forced to increase productivity and cut costs.

Another part of the transportation sector that has been deregulated is the railroads. The Staggers Rail Act of 1980 returned ratemaking to the railroads. It allowed the railroads to consolidate their operations, coordinate transportation of goods with motor carriers, and use contractual arrangements in the ratemaking process. The initial result of the Staggers Act was that rail freight rates rose more rapidly than before. However, this was because of a need to catch up with costs and markets. Once this is over with, rates should increase more moderately, especially for those users who make intensive use of the railroads for either shipping or transportation.

In trucking, economic deregulation has eased barriers to entry and promoted a more market-determined pricing structure. As a result, a significant increase in the number of new carriers has occurred, and even after making allowance for the greater failure rate, the number of firms in the trucking business today is clearly much greater than before. Not surprisingly, many shippers have been able to obtain lower rates. Deregulation has also affected labor costs as a result of competition from nonunion truck drivers and hard times for many motor carriers.

Other sectors of the economy have been or are in the process of being deregulated and these, too, will contribute to a moderation in price increases. In health care, new regulations designed to increase

competitive forces within the industry are already restraining the rate of health care inflation. In telecommunications, the restructuring of the telephone industry will ultimately bring major benefits to both that industry and its customers in the form of increased numbers of communication networks, services and products. Telecommunication technology also promises to help business in general improve its efficiency. Finally, financial services have been deregulated with one result, higher interest rates. These higher rates, coupled with the new savings and checking products that the banks can offer, will in time contribute to larger savings flows and less speculative borrowing. Obviously this will enhance capital formation, which is so necessary for business investment, while at the same time keeping spending patterns from becoming excessive.

Sticking with the financial area, one must not overlook the present thrust of Federal Reserve monetary policy. Although the Fed's commitment to monetarism may seem less than total to the diehards, it nevertheless is a key factor in its current monetary objectives. Of course, there are those of the monetarist persuasion who would argue that the Fed has already compromised its stance on inflation. They point to the sharp rise in the money supply that occurred from the middle of 1982 to the middle of 1983. However, nonmonetarist economists would not necessarily agree with this conclusion for several reasons. For one thing, part of the rapid increase in the basic money supply was the result of inflows of investment funds into NOW and Super-NOW bank accounts.

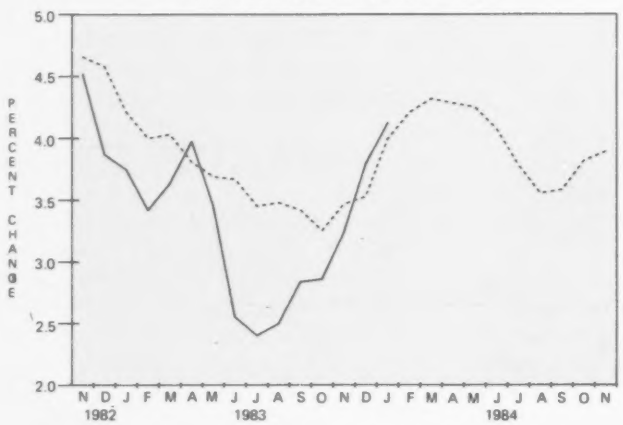
Since depositors can obtain money market rates on these checking accounts, it is conceivable that a big chunk of these funds might not be money available for spending, but simply another form of savings. In addition, the velocity, or turnover of money, fell much more than usual during the last recession and has yet to regain its previous peak, suggesting that there has been a secular change in the relationship between money and the economy. As a matter of fact, the drop in velocity was so steep that for the first time in modern history, it is not only below its prerecession peak in the second year of economic recovery, but it is no higher than levels first reached four years earlier. One wonders if the Fed has been liberal enough in providing money to the economy, rather than being overly generous to the point of starting a new round of inflation and the expectation of inflation.

Regarding inflation psychology, one need only look at the real world to see a dramatic change. Well into the second year of economic recovery many businessmen still complain that they cannot raise prices even where markets have firmed. For their part, consumers remain reluctant to pay higher prices, preferring to shop around or do without. This anti-inflation psychology can also be seen from a look at the precious metals. At roughly $400 an ounce, gold is less than half the peak price reached four years ago; silver is less than one-fifth its 1980 price. And the precious metals are not the only commodities that are below their previous peaks. Besides oil, many food commodities remain below their earlier highs as are such key industrial commodities as copper, aluminum, and lumber.

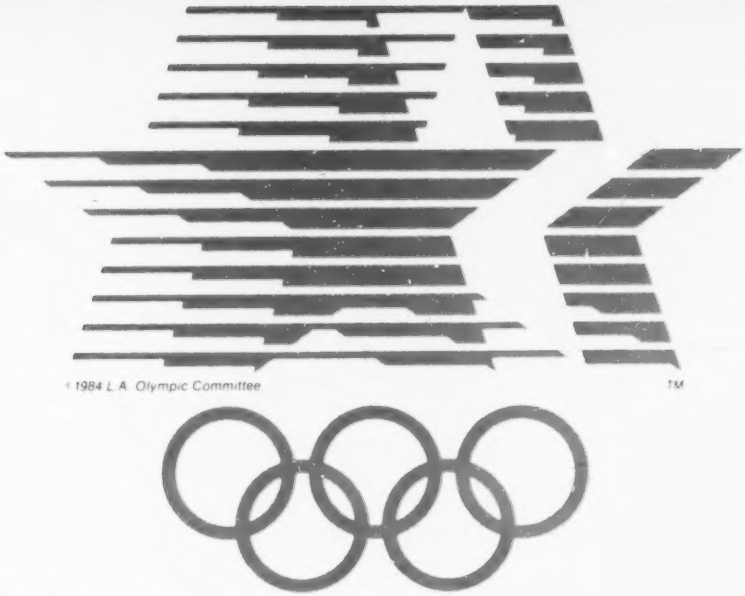
Conclusion

It is true that the various price indexes have risen more rapidly in the past six months than previously. The consumer price index, for example, has gone up at a five percent annual rate in the past six months compared with a 3½ percent rate of rise in the previous half year and less than a two percent clip during the six prior months. Even taking out the noncyclical influences of food and energy, the fact remains that the underlying rate of inflation has picked up. However, this should not be worrisome. The recent acceleration in inflation looks bad only in comparison with its earlier slowing, which was much greater than average (Chart II). You will recall, for example, that between October, 1982 and February, 1983 the overall consumer price level fell—the first four-month decline since 1958.

CHART II
12-MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX
CURRENT RECOVERY (LINE) VS.
AVG. OF 7 PRIOR RECOVERIES (DOT)



The fact that inflation has picked up a bit is not unusual in the second year of an economic recovery. However, the odds seem against the rate of inflation accelerating much beyond current levels. If inflation does remain close to its present rate, it will mean that we will have gone a full cycle ratcheting downward the rate of inflation after six cycles of seeing inflation worsen. And just as the previous stepups in inflation turned out to be self reinforcing, so this step down in inflation should be a signal to the various economic and political units in the United States and worldwide that, at long last, we may have, indeed, turned the corner in the battle against inflation, and may be heading toward eventual price stability. H



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Debt Bomb Defused?

Since summer 1982, the issue of developing country debt has become an increasing preoccupation among both the media as well as the analysts on Wall Street. This has not been without good reason, in view of the well-documented inability of some developing countries to fully service their debt. However, another trend has developed during this time which has not received as much publicity. This trend deals with changes in the economic fundamentals that led to the country debt problem in the first place. These changes, if nothing else, have bought much-needed time to implement a more permanent solution.

Lower Interest Rates ...

Let's look at the big picture first. As you will undoubtedly recall, interest rates have receded. Although up from their lows reached about a year ago, most interest rates here and abroad remain substantially below their 1980-82 peaks. In turn, this has produced at least two beneficial effects. First, of course, it has lowered the cost of servicing debt. It is believed that each percentage point decline in market rates of interest saves such countries as Mexico and Brazil nearly three quarters of a billion dollars a year each in interest costs alone.

The second effect of lower interest rates is equally as important. It allowed economic recovery to get underway in the United States and in other major industrial countries. In turn, this expanded the markets for many of the goods produced and exported by these debtor nations. Our burgeoning deficit in merchandise trade is testimony to this: In 1983 the U.S. ran a record merchandise trade deficit with the rest of the world—taking in $61 billion more in imports than it sent abroad in exports. Of this, over $16 billion, or 26¼ percent, reflected a deficit in trade with Latin America. Of course, a deficit for us means a surplus for them, thus expanding their net export income.

More goods exported, by themselves, do not necessarily enhance a country's ability to service its debt. Other adjustments must be made as well—and these have been made. For one thing, imports have been slashed. In some cases, the flow of merchandise into developing countries has been cut by more than 50 percent. This was accomplished by a combination of policies, some good and some bad.

... Belt-Tightening ...

In an effort to improve their trade and current accounts, many developing countries tightened their belts significantly. Taxes were raised, government spending was cut while domestic interest rates were increased. To further help cut imports and promote exports, these debtor countries devalued their currencies in the foreign exchange markets. However, to hasten the process, some also turned to trade and capital controls, in order to ensure that the import of goods and the export of capital would be cut down.

TABLE I

MERCHANDISE TRADE AND CURRENT ACCOUNT BALANCES OF SELECTED DEVELOPING COUNTRIES

(billions of U.S. dollars)

	Merchandise Trade			Current Account		
Country	1981	1982	1983	1981	1982	1983
Argentina	0.7	2.7	3.5	4.7	−2.4	−2.5
Brazil	1.2	0.8	6.5	−11.7	−14.5	−6.2
Chile	−2.4	0.3	1.0	−4.7	−2.3	−1.1
Mexico	−4.1	6.9	11.7	−12.5	−2.7	3.5
Peru	−0.5	−0.6	0.1	−1.7	−1.7	1.1
Venezuela	7.8	2.7	7.0(e)	4.0	1.5	2.0
6 High Debt Latin Countries	2.7	12.8	29.8	−21.9	−22.1	−3.2

Source: International Monetary Fund

As you can see from Table I, the net result was nothing short of dramatic. Both the trade and current accounts of the major Latin American developing countries have improved markedly. On the merchandise trade basis, the six high debt Latin countries boosted their aggregate trade surplus from less than $3 billion in 1981 to nearly $30 billion in 1983—a tenfold increase! Shifting to the current account, the six high debt Latin countries

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ran a combined current account deficit of nearly $22 billion in 1981. Two years later, this was slashed to little more than $3 billion—an 85 percent improvement.

The combination of lower interest rates and rising earnings on the export of goods and services has improved the debt service ratios of many developing countries, as has the stretchout of the repayment of principal. Table II shows that the ratio of interest payments to exports of the six high debt Latin countries declined from 35.8 percent in 1982 to 35.2 percent in 1983. As these countries have once again begun earning more abroad than they spend abroad, their reserves have been bolstered. Table III shows the extent to which the high debt countries' reserves can cover their import bills. In 1982, the six high debt Latin countries could cover only 4.7 months' imports with their reserves; by 1983, with imports reduced and bank balances rising, this improved to more than six months.

TABLE II

DEBT SERVICE RATIOS OF SELECTED DEVELOPING COUNTRIES

(billions of U.S. dollars, percent)

	Interest Payments		Export Earnings (goods and services)		As % of Exports	
Country	1982	1983	1982	1983	1982	1983
Argentina	2.972	2.904	10.657	11.092	27.9%	26.2%
Brazil	12.550	12.270	23.507	25.512	53.4	48.1
Chile	2.041	2.256	4.932	5.401	41.4	41.8
Mexico	10.499	11.234	30.717	29.758	34.2	37.8
Peru	1.229	993	3.884	3.906	31.6	25.4
Venezuela	4.151	3.941	19.500	19.790	21.3	25.8
6 High Debt Latin Countries	33.392	33.598	93.197	95.459	35.8	35.2

Source: International Monetary Fund

Perhaps the key economic fundamental responsible for the country debt crisis was the sudden rise in oil prices some ten years ago. As you will recall, this caused the oil exporting countries to develop massive foreign trade surpluses. To compound matters, the oil-exporting countries were initially inclined to invest the biggest portion of their revenues in assets of very short maturities. Furthermore, the oil exporters directed their investments into those countries and currencies that promised the greatest safety of principal. Thus, large amounts of money flowed into the United States, landing mainly in Treasury bills and in the major U.S. banks.

Meanwhile, those countries that were importers of oil soon developed very large trade deficits. Indeed, for the first time in modern history, the same countries ran consistent and growing payments deficits year after year because the price of oil was permanently altered relative to the giant matrix of commodities worldwide.

TABLE III

RESERVES TO IMPORT RATIOS OF SELECTED DEVELOPING COUNTRIES

(millions of U.S. dollars)

Country	Latest Month	Total Reserves (including gold)	Average Monthly Imports (1983)	Year-Earlier Import Cover (in months)	Latest Import Cover (in months)
Argentina	11/83	2,638.0	317.8	7.7	8.3
Brazil	12/83	4,582.5	1,284.2	2.5	3.6
Chile	12/83	2,696.4	186.8	8.3	14.4
Mexico	10/83	3,828.0	1,207.4	1.5	3.2
Peru	9/83	2,423.7	315.6	5.7	7.7
Venezuela	1/84	11,037.0	1,132.0	8.8	9.8
6 High Debt Latin Countries		27,205.6	4,443.8	4.7	6.1

Source: International Monetary Fund

... And Higher Commodities' Prices ...

However, as you can see from Table IV, the relative price trend of oil versus other commodities has changed dramatically since the end of the U.S. recession in 1982. Industrial raw material prices have climbed 26 percent during this time while agricultural prices are up 27 percent. By contrast, the spot market price of oil fell 14½ percent during this time. The importance of this development should not be underestimated. Quoting from the January 1983 Economic Report: "Prices of the goods that developing countries export must return to their proper position relative to other prices especially oil, if these countries are ever to reduce their debts to more manageable proportions."

Notwithstanding these rather impressive economic accomplishments, there remain clouds on the country debt horizon. For one thing, the maturity structure is still too short. Although the proportion of developing country external bank debt due within one year has decreased somewhat, it is still uncomfortably high. While only 34 percent of U.S. government debt is due within one year and 48 percent of Corporate America's debt has the same structure, nearly 53 percent of the debt of the six major Latin debtors has a one-year maturity. Obviously, the more debt with a short maturity, the more it must be rolled over.

Besides the almost continuous need to refinance, short-maturity debt tends to be sensitive to market rates of interest. And all too often, market interest rates are determined by conditions in the United States such as Federal Reserve monetary policy, as well as Washington's budget deficits and associated Treasury financings. To the extent both impact the dollar's exchange rate, you can see where yet another burden is being placed at the doorstep of the debtor nations that is not within their control. The January 1983 Economic Report

discussed the need for the development of a mechanism to allow countries to reduce their dependence on fluctuations in the cost and availability of short-term credit, pointing out that debt burdens could be reduced "if a facility were made available to governments that would permit them to exchange short-term debt for long-term debt (or equity) as private sector companies do." The sooner we can reduce the current round of ad-hoc reschedulings, the sooner confidence will return to both the banking system and the borrowing countries. That we are heading in such a favorable direction can be seen from the multi-year rescheduling of maturities now being negotiated.

Despite this, country debt will continue to be extremely sensitive to interest rate developments mainly as they originate in the United States. The burden for the developing countries comes from the cost of money—not the interest rate spread. While there is a growing recognition among bankers that some adjustment of interest rates charged on loans to developing countries might be necessary, central to money costs are U.S. fiscal and monetary policies. If Washington were to make meaningful progress in reducing its budget deficit, interest rates would probably fall without the Federal Reserve having to pump money in and risk a new round of inflation.

TABLE IV

COMMODITY PRICE TRENDS

	November 1982	Latest Month	% change from Recession Trough
Raw Industrials Index (1967 = 100)	229.30	289.60	26.2
Agricultural Products Index (1980 = 100)	73.50	93.30	26.9
Cacao, Brazil (cents/pound)	60.42	90.41	49.6
Cotton, Egypt (cents/pound)	123.80	162.85	31.5
Rubber (cents/pound)	42.10	57.30	36.1
Soybeans ($/Metric ton)	213.00	237.00	11.3
Sugar, Brazil (cents/pound)	8.27	11.59	40.1
Metals Index (1980 = 100)	74.60	74.40	−0.3
Bauxite (cents/pound)	198.72	168.28	−15.3
Copper (cents/pound)	71.57	67.39	−5.8
Iron Ore (cents/pound)	25.17	22.30	−11.4
Nickel (cents/pound)	320.00	320.00	0.0
Tin (cents/pound)	564.00	566.00	0.4
Petroleum (dollars/barrel) Saudi Arabia (Ras Tanura)	33.40	28.60	−14.4

Sources: International Monetary Fund, Commodity Research Bureau Inc.

On the other hand, the Fed should allow enough money into the system to keep the U.S. economy growing. It is one thing for the Federal Reserve to want to achieve slower economic growth in order to avoid overheating and a revival of inflation. It is quite another to pursue this objective to the point where the risk of recession rises—as might be the case in 1985. But a recession is not necessary to put the kibosh on the improvement in country debt; enough of a slowing of U.S. economic growth will produce the same result. For less growth here means reduced demand for products produced from abroad—especially from the borrowing countries. In turn, this would reduce their exports, and, possibly, the prices of the commodities they sell abroad as well. Clearly, this would cut into export earnings with results not hard to imagine. As it is, exports from many developing countries are running into the wall of protectionism thrown up by the U.S. and other industrial countries in the name of helping domestic industries. These protectionist walls have to come down if debtor nations are to have a chance of getting back on their feet.

... Improve Developing Country Finances

Of course, these debtor nations have a lot they must do for themselves. There is an obvious need among the major debtor countries in Latin America to make more progress in significantly reducing their inflation rates. In the overwhelming number of cases, year-on-year inflation in 1983 was far worse than in previous years—a development only partially explained by their depreciating foreign exchange rates. Naturally, slowing down inflation in these countries where living standards have already been squeezed to the bare minimum by currency devaluations, import restrictions, and other stringencies will not be easy. However, it must be done if these nations are to return to the economic playing field as healthy and equal participants.

In sum, the nature of the country debt situation has changed compared with 1982. Then, it was economic in scope as a result of the combination of four years of recession, high interest rates, declining commodity prices and soaring oil prices. But adjustments have been made by the borrowing countries, helped by a reversal of these external economic circumstances: An economic recovery, declining interest rates, rising commodity prices and falling oil prices. The ultimate objective, of course, is for the borrowing nations to return to enough of a state of financial health so they can access the credit markets normally. While much needs to be done—more in some countries than in others and over longer periods of time—much has already been achieved.

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